Investment Insights

Q&A: Multi-asset-multi-factor-strategies employ the full set of tools in our toolkit

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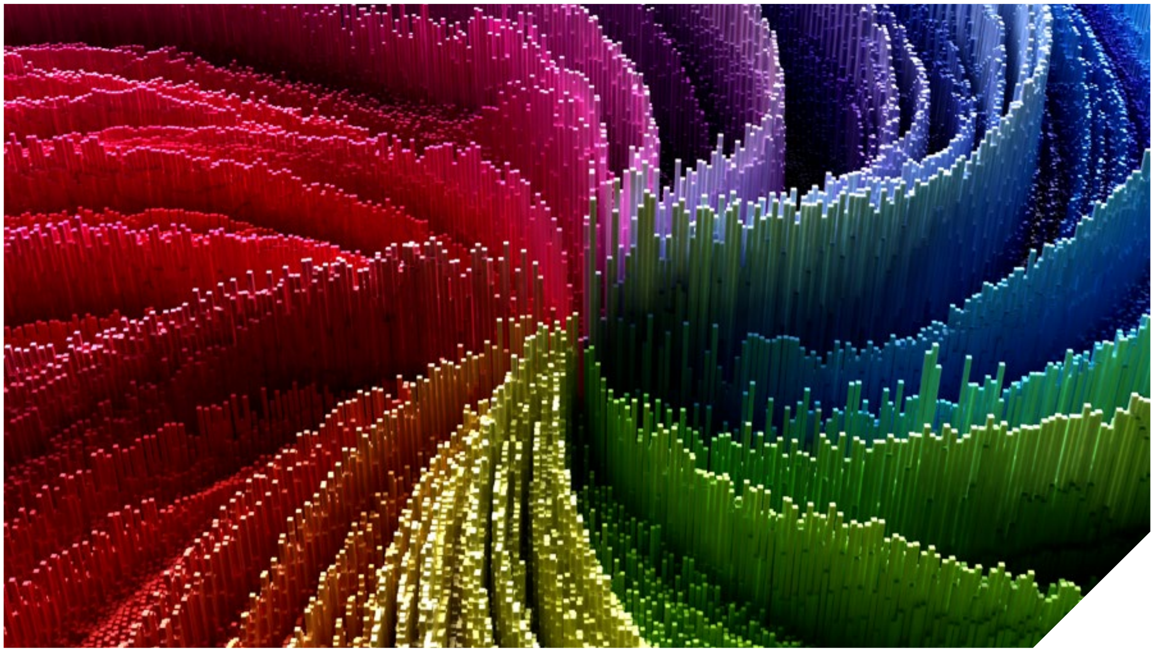

At Invesco, investment professionals across different investment centers and regions work alongside one another to establish a meaningful multi-asset multi-factor investment process.

We asked four of them to join us for a roundtable discussion: Dr. Harald Lohre and Alexandar Cherkezov from Invesco Quantitative Strategies in Frankfurt, Jay Raol, Ph.D, from Invesco Fixed Income in Atlanta and Stephen Quance, Director of Factor Investing in Singapore.

Alexandar Cherkezov
Portfolio Manager,
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Dr. Harald Lohre
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Stephen Quance
Director of Factor Investing Asia-Pacific

Jay Raol, Ph.D.
Senior Macro Analyst,
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Q: What is your main motivation for investigating multi-asset multi-factor strategies?
Dr. Harald Lohre: At Invesco, we have a long history managing multifactor equity strategies, often as part of multi-asset mandates. Thus, expanding the concept to other asset classes seems only natural. In fact, there is a substantial amount of academic research showing how useful it is to extend factor investing beyond traditional equity.

Alexandar Cherkezov: Factor investing is highly transparent, and it is structured along the relevant drivers of risk and return. For bonds, this is probably more important than ever in the current environment: with bond yields hovering at record-lows, there is no place else to turn when it comes to delivering attractive levels of return.

Stephen Quance: I fully agree with Alexandar. Nevertheless, let me also stress that multi-asset multi-factor investing should not be confined to periods of low interest rates. Striving for maximum diversification to pursue high risk-adjusted returns does not go out of fashion when rates are higher. Rather, a multi-asset multifactor strategy is in many ways the final frontier on the broad spectrum of factor utilization.

Q: How does your strategy differ from other multi-asset portfolios?
Jay Raol, Ph.D.: In our approach, securities are selected for their expected exposure to quantitative and evidence-based factors. At the core sits a body of research, much of it taken from academia, about asset pricing and market dynamics.

Stephen Quance: This approach is different from picking a security that you think is undervalued. It is more systematic in nature, more scalable. And, it becomes easier to maintain broad diversification at the security level. Factor investing should not be seen as a replacement for traditional alpha seeking strategies; there will always be a place in the market ecosystem for them. But, because the mentality, process and sources of returns come from different places, the return stream will likely be dispersed as well.

Q: What are the potential advantages of including multiple asset classes in a factor strategy? In particular, what makes you confident that factors can work in realms other than equities?
Jay Raol, Ph.D.: Why should risk premia and behavioral biases be limited to equity investors only? The data confirms that the rationale underpinning equity factors also apply to other asset classes. Three important equity style factors – value, quality and momentum – apply equally to fixed income. There is a strong economic rationale for all three, and they display statistical characteristics similar to the equity space. Together, this makes us confident in building our multi-asset factor library.

Dr. Harald Lohre: Factors often span traditional asset classes. For instance, equities and high-yield bonds often move together, or show positive correlations. If we identify a factor that helps capture this correlation, the resulting portfolio might exhibit superior risk and return characteristics compared to a standard asset class allocation that ignores common factors.

Stephen Quance: Yes, it's like an extra degree of diversification that is harder to manage piecemeal. And, we all know true diversification is a powerful element of risk control.

Q: Diversification seems to permeate your work on multi-asset multi-factor strategies. But, isn't purely risk-based allocation to assets and factors a rather passive approach to investing?
Alexandar Cherkezov: In fact, quite the opposite is true. For one thing, the overarching risk model requires a decent amount of active decision making. To start, we need to define the major asset classes and factors. Then, the underlying factor strategies themselves are active strategies that might significantly deviate from standard market investments.

Dr. Harald Lohre: And even though there is plenty of empirical evidence supporting the usefulness of style factors, there is only little evidence that these factors can be timed ex-ante. Thus, a maximum diversification approach is a prudent choice.

Q: Let's move on to a different topic. With factor strategies gaining ever more popularity, aren't you afraid that some of these factors might become too crowded?
Dr. Harald Lohre: We put a lot of effort into identifying economically meaningful factors that have a sound basis for adding value. We then consider the most effective way to capture them over the long-run. For instance, take value: we observe a value premium in the data using a number of different definitions for value, including book-to-market, earnings yield, cash flow yield etc. Equally important considerations are scalability, concentration and liquidity. With solid rationales and thoughtful execution, we maximize the likelihood of realizing positive premiums over time.

Jay Raol, Ph.D.: We are constantly iterating on existing factors to better refine their risk and return profiles. Markets are always evolving and adapting to innovations, including factor research. Therefore, we must continue investing in our own research process to stay at the forefront.

Q: Speaking of research: tell us about your current research agenda.
Jay Raol, Ph.D.: We have a formal process to review promising developments that could lead to improvements in our process. For instance, we are currently looking into using new data sets, like satellite imagery, and new algorithms, like machine learning. We are also looking to include macroeconomic factors, such as growth or inflation, which can complement style factors. Factors are an iterative research-driven process. Most of the work we do fails to bear fruit, but occasionally we find new breakthroughs that advance our capabilities.

Dr. Harald Lohre: Likewise, it is always important to research the interaction between factors. Understanding the drivers of a single factor might be interesting, but the full power of the approach is unlocked by combining investable factors that efficiently deliver genuine return streams in a single portfolio.

Q: Turning to instruments: can a multi-asset multi-factor strategy only be implemented with derivatives? In other words: is long-short the only way?
Alexandar Cherkezov: Yes – and no. With long only positions, you can indeed build meaningful factor exposures, but they will also contain a considerable level of traditional market risk.

Jay Raol, Ph.D.: If you approach factor investing from a long/short perspective, the building blocks for portfolio construction are much less correlated, and you will be able to exploit the full potential of the strategy. Using derivatives is the most efficient way to implement such a strategy.

Q: If you were to quickly summarize the main appeal of multi-asset multi factor investing ...
Stephen Quance: The concept is clearly designed to be a strategic holding. It is also expected to have low correlation to any single asset class, like stocks or government bonds. This is wonderful news when one asset class declines sharply. Investors simply need to have realistic expectations, for instance, if stocks take off. The strategy shouldn't be expected to keep up in the short term. Slow and steady is more the game plan here.

Dr. Harald Lohre: As multi-factor, bespoke and more complex solutions become increasingly commonplace, a logical question is: how far can this go? A multi-asset multi-factor strategy utilizes all of our knowledge and experience with factor investing, and combines it with expertise in managing multi-asset strategies. By capitalizing on factor exposures across traditional asset classes, multi-asset-multi-factor strategies employ the full set of tools in our toolkit.

Thank you all very much!

Important information